Home Mortgage Interest Deductibility
Dealt a Blow by Supreme Court of Canada

For most Canadians, the purchase of a home represents the single biggest financial obligation of a lifetime. And for all but a fortunate few, purchasing a home means taking on a mortgage and, with it, decades of interest payments that will eventually total far more than the original cost of the home. It's not surprising, then, that Canadian taxpayers have repeatedly turned their minds to ways to minimize that unavoidable interest cost, at least on an after-tax basis.

Under Canadian tax law, interest is deductible for tax purposes only if it is paid on money borrowed to earn business or property income. Interest on loans to finance personal expenditures, such as a house, car, boat, vacation, or home improvements, is not deductible, with some specified exceptions, such as interest paid on government-sponsored student loans. As a consequence, most of the tax planning around home mortgage interest has been directed toward "converting" non-deductible home mortgage interest into deductible interest incurred for business or investment purposes. There have been some taxpayer victories along the way, but a recent Supreme Court of Canada decision may have signalled the end of the road for such tax planning strategies.

A little background: In the mid-1990s, a taxpayer by the name of Singleton, who was a partner in a law firm, withdrew funds from his partnership capital account and used those funds to purchase a house. He then borrowed funds to replace the money in the capital account and claimed an interest deduction for that borrowing. The Canada Revenue Agency denied the deduction, arguing that the overall purpose of the series of transactions was to purchase the house, so the related interest costs were not deductible. The taxpayer appealed, and eventually, the Supreme Court of Canada determined that the use to which the borrowed funds were put (that is, to replenish the taxpayer's capital account at his partnership) was sufficient to make interest paid on those funds deductible. It seemed that, with proper planning and the right structure, home mortgage interest deductibility could effectively be achieved.

A decade or so later, a couple by the name of Lipson carried out a somewhat similar transaction, in which the wife borrowed funds to purchase shares in her husband's investment company. The husband then used those funds to purchase a family home. A mortgage was then taken out on the family home and the monies used to repay the original share purchase loan. Since both the original loan and the mortgage had an investment purpose (i.e., they were related to the purchase of shares), and not a personal one, the taxpayers claimed a deduction for the interest paid on both. That interest deduction was denied by the Canada Revenue Agency, and, as in Singleton, the taxpayer appealed against the assessment. However, in this case, both the Tax Court of Canada and the Federal Court of Appeal found in favour of the CRA's position and denied the interest deduction. The taxpayer appealed to the Supreme Court of Canada, which recently decided that the lower courts were correct in denying the interest deduction to the taxpayer.

The Supreme Court of Canada's decision in *Lipson v. Canada* (available at http://scc.lexum.umontreal.ca/en/2009/2009scc1/2009scc1.html) was a narrow one, with four of the justices finding against the taxpayer while three others disagreed, holding that the interest deduction should have been allowed. As is often the case where the Court is split, the decision doesn't provide taxpayers or their advisors with firm guidance on the question of what now does or doesn't constitute allowable tax planning with respect to home mortgage interest deductibility.

In denying the deduction, the majority of the Court relied upon the general anti-avoidance rule (GAAR) and looked at the overall result of the series of transactions carried out by the taxpayers to determine that the result obtained was a violation of that rule and should not be allowed. While similar planning had been employed in the *Singleton* case, the application of the GAAR to Singleton's plan had not been argued before the Court, so the result in *Singleton* was essentially irrelevant to the determination of the Lipsons' situation.

Whether the SCC decision in *Lipson* has driven the final nail in the coffin of home mortgage interest deductibility strategies is difficult to say. There's virtually no limit to the ingenuity of Canadian taxpayers and their advisors, and it's very likely that the courts will be called upon to consider this issue again. However, it's clear that, following the decision in *Lipson*, the possible application of the GAAR will play a part in any future case. It seems that any taxpayer who seeks to arrange his or her affairs to effectively make home mortgage interest deductible will face an uphill battle in claiming that interest deduction.